DIRECTORATE GENERAL FOR INTERNAL MARKET AND SERVICES

CONSULTATION ON IMPLEMENTATION OF ARTICLES 45 – 47 OF THE DIRECTIVE ON STATUTORY AUDIT (2006/43/EC)

COOPERATION WITH NON-EU JURISDICTIONS ON AUDITOR OVERSIGHT

We invite comments by 5 March 2007 at the latest. Earlier responses would be very welcome.

Responses should be sent by email to MARKT-F4-3RDCOUNTRIES@ec.europa.eu. Alternatively you should send comments by post to the European Commission, DG Internal Market and Services, Unit F4 - Auditing, SPA 2 (JII), 02/085 , B-1049 Brussels, Belgium.

All responses will be acknowledged. We will make comments publicly available on the Commission's web-site unless respondents specifically request otherwise. If you send an e-mail response, which includes an automatically generated notice stating that the content is to be treated as confidential you should make it clear in the body of your message whether or not you wish your comments to be treated as confidential.

January 2007

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1. INTRODUCTION

The new Directive on Statutory Audits (2006/43/EC)[i] (the "Directive") applies to auditors and audit firms from both European Union ("EU") Member States and third countries[ii]. The Directive came into effect on 29 June 2006. EU Member States have two years to implement it.

This document seeks views on possible implementing measures under the Directive regarding (a) regulation and oversight of third country auditors and audit entities (Articles 45 and 46 of the Directive); and (b) co-operation with competent authorities from third countries (Article 47).

Following this consultation, the European Commission will consider the need to propose implementing measures to EU Member States and the European Parliament under the comitology procedure.

This consultation paper is based on the following considerations:

- This paper seeks views on the implementation of the Directive with regard to third countries. Whilst implementation is primarily a matter for the EU Member States, the European Commission services are interested in obtaining views on what action the European Commission can take to facilitate this implementation;

- The European Commission is empowered to decide on the equivalence of third country public oversight systems. Such a decision would reduce market fragmentation, contribute to simplification and lead to a better overall quality of audits. The European Commission is also empowered, where appropriate, to grant a transitional period for audit firms from third countries not yet in a position to benefit from equivalence;

- The European Commission has set up and chairs the European Group of Auditor Oversight Bodies ("EGAOB") which is designed to co-ordinate national oversight activities;

- In this context, the EGAOB is the ideal forum for co-operation inside the European Union to further minimise regulatory burdens related to registration procedures for third country audit firms. In the same vein, it needs to be examined what auditing standards and independence rules third country audit firms might have to respect in the EU;

- Rules for co-operation with third country audit regulators on exchange of audit working papers held by EU audit firms and direct transfers of audit working papers and documents by EU audit firms need to be clarified.

2. CONTEXT

2.1. ARTICLES 45 AND 46 OF THE DIRECTIVE 2006/43/EC

Articles 45 and 46 of the Directive apply to audit firms (as well as auditors) of companies incorporated in a third country where the company's securities, including debt or equity, are admitted to trading on an EU regulated market.

Article 45 requires such auditors/audit firms to:

- register with a competent authority in each EU Member State in which their clients' securities are admitted to trading;
- be subject to that EU Member State’s oversight and sanctions.

Under Article 46, an EU Member State may exempt such an auditor or audit firm in whole or in part from its national registration and oversight regime, if:

- an auditor/audit firm of the third country issuer is subject to a third country audit oversight regime which has been recognized by the European Commission as equivalent to the EU regime; and
- reciprocal exemptions (in whole or in part) are applied by the third country to the EU Member State’s auditors/audit firms.

Preliminary estimates indicate that approximately 220 audit firms auditing issuers from 63 third countries have audit engagements with companies having securities listed on one or more regulated markets in the EU.

It should be borne in mind that audit opinions issued by an audit firm, which is neither registered under Article 45 nor covered by an exemption under Article 46 of the Directive, will be void in the EU Member State concerned. This might be relevant to financial statements for financial years starting on 30 June 2008 which will not be made public before mid-2009.

The table[iii] below gives an overview of the situation on the basis of information provided by the public oversight bodies in the Member States:

Third country	Audit Firms concerned	MS where the audited companies are listed	Third country	Audit Firms concerned	MS where the audited companies are listed
Argentina	4	LUX, UK	Lebanon	6	LUX, UK
Aruba	1	UK	Malawi	1	UK
Australia	6	DE, LUX, UK	Malaysia	6	DA, IRL, LUX, UK
Bahamas	6	DK, IRL, LUX, UK	Morocco	4	FR, UK
Bahrain	3	LUX, UK	Mauritius	1	IRL
Barbados	1	LUX	Mexico	7	NL, LUX, UK
Bermuda	10	FR, IRL, SW, LUX, UK	Netherlands Antilles	6	B, DE, ES, FI, FR, IRL, NL, UK
Brazil	8	DE, NL, LUX	New Zealand	5	LUX, UK
British Virgin Islands	12	IRL, NL, LUX, UK	Nigeria	1	UK
Canada	7	BE, DE, FR, IRL, NL, SW, LUX, UK	Oman	1	LUX, UK
Cayman Islands	19	IRL, NL, LUX, UK	Panama	2	LUX, UK
Chile	3	LUX	Pakistan	1	LUX
China	2	LUX, UK	Philippines	5	LUX
Columbia	3	LUX	Qatar	1	UK
Costa Rica	1	LUX	Kuwait	3	LUX, UK

Croatia	3	LUX, UK	Russia	7	LUX, UK
Egypt	4	LUX, UK	Saudi Arabia	1	UK
Guernsey	5	DA, IRL, LUX	Singapore	3	NL, LUX, UK
Honduras	1	LUX	South Africa	7	BE, DK, DE, FR, LUX, UK
Hong Kong	7	LUX, UK	South Korea	14	LUX, UK
India	54	LUX, UK	Switzerland	7	BE, DE, ES, FR. IT, NL, SV, LUX, UK
Indonesia	2	UK	Taiwan	11	LUX, UK
Isle of Man	2	IRL	Thailand	8	LUX, UK
Israel	7	BE, DE, LUX, UK	Tunisia	1	UK
Ivory Coast	1	LUX	Turkey	5	LUX, UK
Japan	18	BE, DE, FR, LUX, UK	Ukraine	1	UK
Jersey	8	DE, IRL, LUX, UK	United Arab Emirates	2	UK
Jordan	2	UK	Uruguay	1	LUX
Kazakhstan	2	LUX, UK	USA	47	BE, DE, FR, IRL, IT, NL, SW, LUX, UK
Kenya	1	UK	Venezuela	2	LUX
Liberia	1	LUX	Zambia	1	UK
			Zimbabwe	2	UK

The figures above are estimates as they still include audit firms exempted in any event from the Directive. The exempted firms are those auditing third country companies:

- having issued securities addressed to professional investors only (securities with a denomination of at least EUR 50.000); or
- falling under the definition of collective investment undertakings other than the closed-end type set out in Article 1 (2) of Directive 2004/109/EC; or
- whose securities are not admitted to trading on a regulated market but only on a multilateral trading facility (MTF). From 1 November 2007, upon the introduction of the Markets in Financial Instruments Directive, such companies could be exempted.

2.2. Article 47 of the Directive 2006/43/EC

In contrast to Articles 45 and 46, Article 47 concerns EU audit firms which might become subject to a third country jurisdiction's oversight, at least when they audit:

- the annual or consolidated accounts of an EU company whose securities are admitted to trading on the third country's securities markets, such as in the US or in Canada; or
- parts of a group whose parent company issues consolidated accounts in a third country. This second case will concern a much wider range of third countries.

The US is one example in this regard. Many EU audit firms currently fall under US oversight. The Sarbanes Oxley Act requires "foreign public accounting firms," which audit or play a substantial role in the audit of an issuer registered with the U.S. SEC, to register with the U.S. Public Company Accounting Oversight Board (PCAOB). As at the date of this consultation, 241 EU audit firms have registered with the PCAOB.[iv]

EU Member State	EU audit firms registered with the PCAOB	EU Member State	EU audit firms registered with the PCAOB
Austria	6	**Luxembourg**	3
Belgium	13	**Malta**	2
Cyprus	2	**Netherlands**	12
Czech Republic	6	**Poland**	6
Denmark	5	**Portugal**	6
Estonia	1	**Slovakia**	2
Finland	5	**Slovenia**	2
France	31	**Spain**	13
Germany	28	**Sweden**	6
Greece	4	**United Kingdom**	60
Hungary	5	**Total EU registrants**	**241**
Ireland	11	**Total foreign registrants**	**1,661**
Italy	12		

Article 47 sets the framework for possible co-operation of EU Member States' competent authorities with the competent authorities of a third country. Co-operation could consist of exchanging auditors' working papers or other documents held by auditors in the European Union.

The Directive requires a legal framework to be established in order to provide adequate protection in two cases: first with respect to professional secrecy rules and second with respect to data protection rules. Co-operation with third countries should, however, not undermine such rules.

3. ISSUES FOR CONSULTATION

The European Commission services are considering the need for implementing measures under the Statutory Audit Directive. Such implementing measures would not replace what EU Member States should do when implementing a directive into national law. However, implementing measures could lead to more consistency and certainty for European capital markets and, at the same time, to less cost for the market participants.

Before considering the need to propose implementing measures, the European Commission services wish to obtain the views on the following possible actions.

3.1. POSSIBLE WORKSTREAM ON THE BASIS OF ARTICLE 46

3.1.1. ASSESSMENT AND DECISION ON EQUIVALENCE OF THIRD COUNTRIES

Under Article 46 of the Directive, an EU Member State may rely on regulation of a third country and exempt a third country auditor/audit firm (in whole or in part) from its registration and oversight regime. One of the main conditions for granting such an exemption is **equivalence** of a third country public oversight system.

For this purpose, under Article 46(2) of the Directive, the European Commission is required to assess in co-operation with Member States and to decide on the equivalence of the third country's public oversight system.

A decision on an EU-wide basis in the near future would have following benefits:

- **reduce market fragmentation**: if equivalence is established in the entire European Union, the investors and the capital markets will benefit from a more certain legal environment for cross-border transactions and will not be confronted with fragmented solutions. This seems to be the best way for keeping an integrated European capital market attractive for issuers from third countries. For example there would be major difficulties if an audit opinion was deemed to be void in a certain EU Member State under Article 45 (4) of the Directive but recognised as valid in a second EU Member State;

- **simplification**: a Commission decision will reduce the work-load and the cost for the public oversight bodies in the EU Member States. If no equivalence decisions were taken, each competent authority in different EU Member States would not only have to assess each audit firm individually at the point of registration but also on a permanent basis by carrying out quality controls. The cost of this would be charged to the audit firms. In addition it cannot be excluded that this cost will have to be ultimately borne by the third country issuers and by the capital markets in Europe;

- **focus on audit quality in third countries:** unlike assessment of individual audit firms and their networks, the assessment of a third country oversight system as a whole gives a better insight into the actual environment within which an audit firm strives for audit quality. The other option would be to assess the networks within which the audit firms operate. This option, however, would not allow for an in-depth and objective assessment of audit quality because the internal environment within these audit firm networks is not sufficiently transparent.

Where a decision on the equivalence of public oversight is taken, Article 46 (2) provides for the following horizontal criteria third country public oversight systems should offer: (i) an independent external quality assurance, (ii) effectiveness of domestic investigations and penalties, and (iii) a comprehensive set of responsibilities of the public oversight.

The application of horizontal criteria should be principles-based as equivalence does not mean identical. As a consequence, these criteria would be met if third country systems have sufficient public integrity and are independent from the audit profession. In addition they should have the ability to co-operate with the public oversight bodies in the EU Member States on sensitive issues.

Question 1:

Do you have further comments, or concerns to share, on the equivalence?

3.1.2. TRANSITIONAL SOLUTIONS UNDER ARTICLE 46

It is clear that public oversight does not yet exist in all the third countries mentioned above. In view of this situation, two approaches are conceivable. The first avenue could be to require the third country audit firms concerned to register in the various EU Member States now and to postpone the assessment of audit regulation in such third countries under Article 46 to a later stage. The second avenue would be to assess the existing third country systems as to whether there is a willingness and realistic possibility of moving towards public oversight within a reasonable timeframe.

The European Commission services consider that the second avenue is more promising. The reasons for this are twofold: first, this approach may reduce administrative costs in Europe and second, it provides incentives for third countries to move to a principle-based public oversight. Article 46 (2) of the Directive allows the European Commission to adopt transitional solutions. Such transitional solutions would allow audit firms auditing non-EU clients for financial years starting before 30 June 2008 to continue their activity. It would apply from 30 June 2008 only for a limited period of time. The length of transitional period would amongst other factors depend on the third country in question.

Question 2:

Do you have comments on the need for transitional measures?

3.1.3. PRIORITIES FOR THE ASSESSMENT OF THIRD COUNTRIES

Given its scope and extent, the work programme for assessing third countries should be prioritised based on the following criteria:

- **Number of companies concerned:** Third countries with a high number of companies with transferable securities, including debt and equity securities, admitted to trading on an EU regulated market would be given priority in the assessment;
- **Advanced oversight structures in place:** Countries with more advanced oversight structures in place would be given priority in the assessment. One indication of the presence of advanced oversight structures may be the third country's membership in the International Forum of Independent Audit Regulators (IFIAR);
- **Major world economies:** Major non-EU jurisdictions (USA, Japan, China, India and Russia) with which the European Commission has regulatory dialogues in the area of financial services would be given priority in the assessment as there are common interests and concerns on financial stability, which include co-operation on accounting and auditing.

Against this background, initial assessments have been started on the following 35 countries:

Argentina, Australia, Bahamas, Bermuda, Brazil, British Virgin Islands, Canada, Cayman Islands, China, Croatia, Egypt, Guernsey, Hong Kong, India, Indonesia, Isle of Man, Israel, Japan, Jersey, Kazakhstan, Lebanon, Malaysia, Morocco, Mexico, New Zealand, Philippines, Russia, Singapore, South Africa, South Korea, Switzerland, Taiwan, Thailand, Turkey, and the US.

The assessments will be carried out by the European Commission, in cooperation with the European audit regulators represented in EGAOB. The third country assessments will be based amongst others on a survey conducted by the International Organisation of Securities Commissions (IOSCO) in 2004, reports of the World Bank prepared in the context of its ROSC programmes and third country responses to the European Commission's questionnaire of June 2006. Finally, information available under the compliance programs run by the International Federation of Accountants (IFAC) will also be considered.

Question 3:

Do you have any comments or observations on the above list of third countries? Do you have specific information on those third countries which you would like to share with the European Commission services and if so, which?

3.2. POSSIBLE (ADDITIONAL) WORKSTREAM ON THE BASIS OF ARTICLE 45

Under Article 45 of the Directive the EU Member States shall under certain circumstances register and supervise third country auditors on their own. Registration might be necessary in the following cases:

- **Case 1:** where third countries do not qualify for an equivalence decision under Article 46 (see section 3.1. above); the third country audit firm must, in such a case, register with the relevant public oversight system(s) in the respective EU Member State(s) since one of the conditions for exemption under Article 46 of the Directive is not fulfilled;

- **Case 2:** even where public oversight systems in a third country are considered to be equivalent, the EU Member States may use the option granted in Article 46 (1) of the Directive to modify the registration requirements under Article 45.

- **Case 3:** where audit firms from third countries fall under transitional arrangements, EU Member States may apply national registration and oversight requirements during transitional period.

These three cases show that more a precise understanding of how the registration systems in the EU Members States could interact in practice is needed (including assessment of additional administrative burdens). The three above-outlined situations may result in fundamentally differing registration requirements across the EU, perhaps even with regard to one third country audit firm or with regard to audit firms coming from the same third country. Such a situation would potentially undermine the utility of the Statutory Audit Directive in terms of fragmentation of capital markets, more costs for audit firms, companies and capital markets and uncertainties about audit quality.

Question 4:

Do you have any comments or observations that you wish to bring to the European Commission's attention as regards the explanation in section 3.2?

3.2.1. POSSIBLE ROLE OF THE EUROPEAN GROUP OF AUDITORS OVERSIGHT BODIES

Under Article 45 of the Directive each EU Member State will have its own registration procedure for third country auditors. Some third country auditors and audit firms may need to register in several EU Member States. This might entail considerable administrative burden for the auditors and audit firms concerned.

In view of this, the European Commission services consider that a system of co-operation in registration procedures between the authorities of the EU Member States would be appropriate to reduce the administrative burden imposed on auditors and audit firms subject to multiple registrations. With such a system, a third country audit firm might, for instance, have to undergo only one extensive registration procedure in one EU Member State. Audit firms would register, where appropriate, with other relevant EU Member State authorities. These authorities would adapt their registration procedures, so as to avoid the duplication of work by using the extensive procedures implemented in the first EU Member State. Such a system would allow guarantees already provided in the EU Member State of first registration to be taken into account.

The European Group of Auditors Oversight Bodies ("EGAOB") set up by the European Commission might be an appropriate forum for discussing this co-operation.

Question 5:

Do you have comments on a concept for co-operation in registration procedures that would aim at reducing administrative burdens and cost?

3.2.2. AUDITING STANDARDS

One of the registration conditions foreseen under Article 45 (5) is that audits must be carried out in accordance with International Standards on Auditing (ISAs) as adopted in accordance with Article 26 of the Directive or with equivalent auditing standards (GAAS).

At present the European Commission has not adopted any ISAs under this provision. The Directive also does not set any deadline for the European Commission to adopt ISAs under Article 26. As a result, third country audit firm might be forced to use the GAAS of each Member State where it has to register in the future. If this were the ultimate solution, there might be the risk of costly solutions leading to market fragmentation and the risk of inconsistencies in audit quality.

In order to address these issues the European Commission could, through comitology, decide to allow for a transitional period the use of ISAs or US GAAS for third country audits (applicable from 30 June 2008). Such a decision would minimise costs for third country audit firms and their clients as ISAs and US GAAS are currently widely used.

Question 6:

Do you have comments on the use of International Standards on auditing and US auditing standards (US GAAS) by third country audit firm for registration purposes for a limited transitional period?

3.2.3. INDEPENDENCE RULES

Another condition under Article 45 of the Directive is that an individual audit firm should meet independence requirements equivalent to those in the Directive. The reference point for assessing such independence rules are Articles 22, 24 and 25 of the Directive[v].

Articles 22, 24 and 25 of the Directive give wide national discretion. There is a risk that the EU Member States might develop individual solutions.

In order to address this risk, it might therefore be useful to work out a comprehensive solution at EU level. Article 45 (6) allows the European Commission to take action if it wishes to. Two options could in principle be envisaged at EU level:

- **Option 1:** perform individual equivalence assessments of third countries' independence rules.

Against this background, the European Commission would carry out assessments of the independence rules applicable in the 35 third countries mentioned in section 3.1.3. If considered equivalent, this would allow the third country auditors in question to use their home country independence requirements.

- **Option 2:** allow for the use of the IFAC Code of Ethics, if deemed equivalent.

The section on independence of the IFAC Code of Ethics may represent an internationally well-known standard. However, the IFAC Code can only be used if its independence requirements would be equivalent to those of the Directive. This is currently an open and unresolved issue. The relevant IFAC committee, the International Ethics Standards Board for Accountants (IESBA) has launched a public consultation to revise the existing Code of Ethics. If after this revision the IFAC Code appears satisfactory, the use of this Code might be allowed for third country audits of companies listed in the EU.

It might also be conceivable to combine the above options.

Question 7:

Do you have any comments on independence issues under Article 45?

3.3. CO-OPERATION REGARDING ARTICLE 47

Article 47 (1) of the Directive states that EU Member States may allow transfer of audit working papers or other documents held by audit firms to non-EU jurisdiction's competent authorities, provided that certain conditions are satisfied. The main conditions which apply are: reciprocity, professional secrecy rules applying to the third country audit regulator and scope for co-operation. The latter is a part of a so-called "adequacy test" that would be decided by the European Commission under the comitology procedure. The "adequacy test" would establish safeguards applying to the processing of documents transmitted from the EU to a third country.

3.3.1. GENERAL CONTEXT

Meeting the "adequacy test", as described above, would justify exempting the audit profession from confidentiality and professional secrecy rules under the laws of EU Member States and allow European audit regulators to transfer information to third country regulators. Along the same line, the principles set by the Data Protection Directive need to be respected as the audit working papers in question usually contain personal data. Therefore, the audit profession and the European companies may wish to express their views on the content of the "adequacy test", as this test would set up, together with the conditions already existing under Article 47, the framework for the exchange of their papers and of their data. Third country audit regulators and European data protection authorities are also directly concerned by Article 47 and are expressly invited to consider whether they wish to make comments.

Question 8:

Do you have any concerns which you would like to make European Commission services aware of?

3.3.2. POSSIBLE SCOPE FOR CO-OPERATION

The "adequacy test" under Article 47 could clarify the scope for co-operation allowing exchange of audit working papers between the competent authorities of an EU Member State and those of a third country:

(a) A non-exhaustive list of documents that can be transferred could be drawn up. The list could cover: audit working papers, papers related to review undertaken by the group auditor under Article 27 of the Directive, other documents coming from auditors (e.g. correspondence with a regulator, etc.) and inspection reports/outcome issued by audit regulators or other regulators. This would ensure common understanding of the scope of the co-operation. This method would allow the exchange of audit working papers with third countries to be brought in line with the European Data Protection Directive;

(b) Documents that are not considered necessary by the European public oversight bodies for an investigation or inspection by a competent authority of a third country cannot be transferred;

(c) Documents transmitted shall be covered by the obligation of professional secrecy, to which persons employed or formerly employed by competent authorities of a third country are subject. This may apply to the list mentioned under letter (a) above, as well as to any other document;

(d) The authorities of third countries should not be allowed to make the transmitted documents public – directly or indirectly. In addition, it should in principle not be possible to use such documents for different purposes or by different authorities, such as tax authorities or courts.

Question 9:

Do you have any comments on the conditions set up in the adequacy test?

3.3.3. DIRECT TRANSFER FROM AUDIT FIRMS

The Directive does not completely exclude a possibility that European audit firms directly transmit their audit working papers to third countries. Such direct transfer, however, raises conflicts with professional secrecy rules in EU Member States' law, which auditors should respect to avoid serious sanctions.

Audit working papers may therefore only be transferred directly by an audit firm to authorities in a third country in exceptional circumstances as outlined in Article 47 (5).

Question 10:

Which circumstances could, in your view, be considered as exceptional?

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[i] The Directive is available at http://ec.europa.eu/internal_market/auditing/directives/index_en.htm.

[ii] For the purposes of this consultation paper, "third country" means any country, which does not belong to the European Economic Area (EU Member States, Iceland, Liechtenstein, and Norway).

[iii] Number of audit firms is based on an assumption that audit firms with similar names form one firm and that audit firms are located in the same third country as their clients.

[iv] Some EU audit firms have registered only to have the future ability to undertake work for issuer registered with the U.S. SEC should an engagement opportunity arise.

[v] The 2002 Commission Recommendation on Independence may provide further guidance to the extent it remains compatible with the Directive. Article 41 (rotation of auditors) and Article 42 (audit committees) are however no reference points for the assessment of independence of individual audit firms.